

Message Text

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PAGE 01 TEL AV 00451 01 OF 04 111223Z
ACTION NEA-10

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P R 111121Z JAN 78
FM AMEMBASSY TEL AVIV
TO SECSTATE WASHDCPRIORITY 0501
INFO AMEMBASSY AMMAN
AMEMBASSY BEIRUT
AMEMBASSY CAIRO
AMEMBASSY DAMASCUS
AMCONSUL JERUSALEM

LIMITED OFFICIAL USE SECTION 1 OF 4 TEL AVIV 0451

E.O. 11652: N/A
TAGS: ECON, EGEN, EFIN, IS
SUBJECT: THE NEP AFTER TWO MONTHS

REF: 77 TEL AVIV 8855 (NOTAL); 77 TEL AVIV 8857 (NOTAL);
77 TEL AVIV 8932 (NOTAL)

1. SUMMARY: ALTHOUGH TWO MONTHS HAVE PASSED SINCE THE
GOI ANNOUNCED ITS NEW ECONOMIC POLICY (NEP) -- FLOATING
THE ISRAELI POUND, LIFTING MOST FOREIGN EXCHANGE CONTROLS
AND REDUCING GOVERNMENT CONSUMPTION AND EXPORT SUBSIDIES --
MOST ISRAELI ARE STILL UNCERTAIN ABOUT WHAT THIS MEANS

FOR THEIR PERSONAL WELFARE. THERE HAS BEEN WIDESPREAD
CRITICISM OF THE SPECIFICS IN THE NEP AND THE FY 78 BUDGET
TIED TO IT, BUT MOST ISRAELIS STILL SEEM TO SUPPORT THE
IDEA THAT REDUCTION OF THE GOVERNMENT'S ROLE IN THE
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PAGE 02 TEL AV 00451 01 OF 04 111223Z

ECONOMY IS DESIRABLE. THE DATA CONCERNING POST NEP
ECONOMIC PERFORMANCE SHOW THAT THE INITIAL INFLATIONARY
IMPACT OF THE MEASURE WAS APPROXIMATELY 11 PERCENT
OVER WHAT WOULD HAVE OTHERWISE OCCURRED; THAT NO LARGE-
SCALE CAPITAL INFLOWS OR OUTFLOWS HAVE OCCURRED; THAT
THE FLOATING EXCHANGE RATE IS DISCOURAGING IMPORTS;
THAT CONSUMERS AND INVESTORS ARE BEING CAUTIOUS ABOUT

MAJOR NEW COMMITMENTS; AND THAT CERTAIN EXPORT INDUSTRIES ARE WORSE OFF UNDER THE NEW PROGRAM THAN THEY WERE PREVIOUSLY. THE LAST POINT MAY BE VERY TROUBLESOME FOR THE GOI BECAUSE PRESSURE WILL BUILD IN SENSITIVE SECTORS FOR A RETURN TO SPECIAL EXPORT INCENTIVES. ONE POINT ON WHICH ALL OBSERVERS AGREE IS THAT THE LIKUD GOVERNMENT HAS BEEN MOST FORTUNATE IN THE TIMING OF ITS CONTROVERSIAL ECONOMIC ACTIONS, BECAUSE THEY HAVE BEEN COMPLETELY OVERSHADOWED IN THE PUBLIC CONSCIOUSNESS AND POLITICAL ARENA BY THE MIDDLE EAST PEACE NEGOTIATIONS. THE GOI HAS CONTINUED TO OPERATE VERY MUCH ON AN AD HOC BASIS AND HAS NOT MADE GOOD USE OF THIS SITUATION. HOWEVER, IT DOES SEEM TO HAVE AVOIDED A BRUISING FIGHT WITH LABOR OVER WAGE POLICY, PARTLY BY MAKING GENEROUS SETTLEMENTS WITH THE MORE TROUBLESOME GROUPS. IN THE MEANTIME, THE ECONOMY WILL NOT SUFFER TOO MUCH FROM THE LACK OF COHERENT GOVERNMENT POLICY. END SUMMARY.

2. PERFORMANCE.

A. PRICES. THE CONSUMER PRICE INDEX (CPI) ROSE A RECORD 11.5 PERCENT IN NOVEMBER (SEE TEL AVIV 10734) AND IS EXPECTED TO TACK ON ABOUT 5 PERCENT MORE IN DECEMBER. THE 1977 JAN/DEC PRICE RISE WILL BE APPROXIMATELY 45 PERCENT. IN THE ABSENCE OF THE NEP, THE INFLATION RATE WOULD PROBABLY BEEN 31 OR 32 PERCENT; THUS THE ADDITIONAL LIMITED OFFICIAL USE

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PAGE 03 TEL AV 00451 01 OF 04 111223Z

1977 INFLATION ATTRIBUTABLE TO THE NEP WAS APPROXIMATELY 11 PERCENT COMPOUNDED.

B. WAGES.

THE HISTADRUT LABOR FEDERATION CAUSED THE GOVERNMENT SOME DISCOMFORT WITH SHORT STRIKES AND BELLIGERENT RHETORIC IN THE PERIOD IMMEDIATELY FOLLOWING THE ANNOUNCEMENT OF THE NEP. SINCE THEN, PERHAPS SENSING THAT IT DOES NOT HAVE STRONG PUBLIC BACKING, LABOR HAS BEEN RATHER DOCILE. NEGOTIATIONS AMONG THE HISTADRUT, THE GOVERNMENT AND PRIVATE SECTOR EMPLOYERS ON WORKERS COMPENSATION TO OFFSET THE HIGH PRICE INCREASES HAVE PROCEEDED SMOOTHLY. THE GOVERNMENT HAS GIVEN SPECIAL WAGE ADJUSTMENTS TO SOME OF THE MORE MILITANT GROUPS, NOTABLY THE AIRPORT AUTHORITY WORKERS, WHO RECEIVED A SPECIAL 30 PERCENT SALARY INCREASE. AN AGREEMENT HAS BEEN SIGNED TO PROVIDE ALL PRIVATE SECTOR EMPLOYEES A SPECIAL 12 PERCENT COST-OF-LIVING (COL) ADJUSTMENT IN JANUARY ON THE FIRST IL 7,616 OF MONTHLY INCOME.

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PAGE 01 TEL AV 00451 02 OF 04 111243Z

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AMEMBASSY BEIRUT

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LIMITED OFFICIAL USE SECTION 2 OF 4 TEL AVIV 0451

PUBLICSECTOR WORKERS WILL GET A SIMILAR ADJUSTMENT. THIS WILL RESTORE REAL WAGES TO SOMEWHERE NEAR THEIR LEVEL OF A YEAR AGO AND PROBABLY WILL BE SUFFICIENT TO KEEP RELATIVE LABOR PEACE UNTIL NEGOTIATIONS START IN MARCH FOR THE APRIL SEMI-ANNUAL COL ADJUSTMENT.

C. EXCHANGE RATE AND FOREIGN RESERVES. THE ISRAELI POUND-US DOLLAR RATE HAS HARDLY MOVED SINCE THE NEP WAS ANNOUNCED AT THE END OF OCTOBER.IT APPEARS THAT IN THE FIRST FEW WEEKS THE BANK OF ISRAEL PURCHASED ABOUT \$50 MILLION NET IN FOREIGN EXCHANGE AND SINCE THEN HAS BEEN NEITHER A NET BUYER NOR SELLER OF SIGNIFICANCE. THE INITIAL BANK OF ISRAEL PURCHASES WERE TO KEEP THE POUND FROM APPRECIATING TOO MUCH. THE DOLLAR-POUND RATE IS CURRENTLY \$1.00 EQUALS IL 15.65. MEANWHILE, THE POUND HAS DEPRECIATED CONSIDERABLY AGAINST MAJOR EUROPEAN CURRENCIES SUCH AS THE DEUTXCHEMARK, SWISS FRANC AND THE POUND STERLING - THEREBY IMPROVING ISRAEL'S COM-
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PAGE 02 TEL AV 00451 02 OF 04 111243Z

PETITIVENESS IN SOME OF ITS MAJOR EXPORT MARKETS. THE BANKING SYSTEM HAS HANDLED ITS NEW DUTIES EFFICIENTLY BUT HAS BEEN SHARPLY CRITICIZED FOR PROFITEERING IN

FOREIGN EXCHANGE OPERATIONS BY MAINTAINING TOO WIDE A BUY-SELL SPREAD. THIS HAS GRADUALLY NARROWED BUT IS STILL WELL ABOVE THE SPREAD SEEN IN MOST FOREIGN EXCHANGE MARKETS.

D. CAPITAL FLOWS. THE GOI PREDICTED THAT THE NEP WOULD LEAD TO SIGNIFICANT INFLOWS FROM OVERSEAS OF INVESTMENT FUNDS HELD BY ISRAELIS AND OTHERS. THIS PHENOMENON STILL MAY OCCUR, BUT NO EVIDENCE OF IT IS YET SEEN. CRITICS OF THE NEP ALSO PREDICTED THAT ISRAELIS WOULD TAKE ADVANTAGE OF THE RELAXED FOREIGN EXCHANGE REGULATIONS TO MOVE CAPITAL ABROAD. NO SIGNIFICANT TRANSFERS OF THIS TYPE HAVE OCCURRED EITHER. THUS, THE NET EFFECT OF THE NEP ON CAPITAL FLOWS SO FAR HAS BEEN NEGLIGIBLE.

E. FOREIGN TRADE. PRELIMINARY IMPORT FIGURES FOR NOVEMBER SHOW A DROP OVER THE PREVIOUS MONTH. SOME ANALYSTS HAVE POINTED TO THIS AS A SIGN THAT HIGH IMPORT COSTS UNDER THE NEP ARE DISCOURAGING IMPORTS - ONE OF THE NEP OBJECTIVES. IN FACT, IT WILL BE SEVERAL MORE MONTHS BEFORE THE IMPACT OF THE NEP CAN BE SEEN ON IMPORT FIGURES BECAUSE OF THE LAG TIME BETWEEN AN IMPORT ORDER AND THE ARRIVAL OF THE GOODS. THE EFFECT ON EXPORTS WILL OCCUR A LITTLE EARLIER. SOME EXPORTERS CAN CHOOSE TO SELL ON THE LOCAL MARKET RATHER THAN OVERSEAS, IF THE PRICE IS BETTER. MOST ISRAELI EXPORTERS, HOWEVER, MUST EITHER SELL TO FOREIGNERS OR NOT SELL AT ALL. THEREFORE, THERE IS A STRONG INCLINATION TO CONTINUE EXPORTING WHILE THE NEW SITUATION IS CLARIFIED. IT IS FROM EXPORTERS THAT SOME OF THE SEVEREST CRITICISM OF THE DECISION TO FLOAT THE POUND AND TO ELIMINATE EXPORT SUBSIDIES HAVE COME. COUNTLESS FIRMS HERE ARE CLAIMING PUBLICLY THAT THEY ARE LIMITED OFFICIAL USE

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PAGE 03 TEL AV 00451 02 OF 04 111243Z

WORSE OFF UNDER THE NEP THAN UNDER THE PREVIOUS SYSTEM AND WILL BE FORCED TO CLOSE THEIR DOORS UNLESS GOVERNMENT ASSISTANCE IS PROVIDED. A SPECIAL GOI COMMITTEE HAS BEEN SET UP TO INVESTIGATE THESE ALLEGATIONS. PRELIMINARY FINDINGS ARE THAT MOST EXPORTERS ARE STILL ABLE TO COMPETE EFFECTIVELY. NEVERTHELESS, THE GOI CAN EXPECT TO RECEIVE CONTINUING PRESSURE FROM POLITICALLY SENSITIVE INDUSTRIES, SUCH AS TEXTILES, WHO ARE FEELING THE SQUEEZE. IT WILL BE VERY DIFFICULT TO RESIST THESE PRESSURES, SINCE MANY OF THE AFFECTED ACTIVITIES ARE IN SUCH DEVELOPMENT TOWNS AS BEERSHEVA, DIMONA, ASHDOD AND NEAR THE LEBANESE BORDER.

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PAGE 01 TEL AV 00451 03 OF 04 111231Z

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EB-08 FRB-03 INR-07 NSAE-00 USIA-06 TRSE-00
XMB-02 OPIC-03 SP-02 LAB-04 SIL-01 OMB-01 NSC-05
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TO SECSTATE WASHDC PRIORITY 0503

INFO AMEMBASSY AMMAN

AMEMBASSY BEIRUT

AMEMBASSY CAIRO

AMEMBASSY DAMASCUS

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LIMITED OFFICIAL USE SECTION 3 OF 4 TEL AVIV 0451

F. SALE OF GOI ASSETS. THE GOI CONTINUES TO TALK BRAVELY OF PLANS TO SELL EXTENSIVE GOVERNMENT ECONOMIC HOLDINGS TO THE PRIVATE SECTOR, BUT ITS EXPERIENCE TO DATE HAS BEEN THAT THIS IS VERY DIFFICULT TO DO. DEPUTY FINANCE MINISTER FLOMIN CHAIRED A SPECIAL COMMITTEE WHICH HAS RECOMMENDED SELLING 50 GOI-OWNED OR CONTROLLED COMPANIES, INCLUDING THE TELEPHONE SYSTEM, SOME GOVERNMENT BANKS, PARTS OF CHEMICAL AND COMPUTER ENTERPRISES AND THE GOI SHARE IN THE ISRAEL AIRCRAFT INDUSTRY. NO BUYERS HAVE BEEN FOUND SO FAR. WHILE IT WILL BE POSSIBLE TO DISPOSE OVER TIME OF GOVERNMENT OWNED STOCK IN MIXED INDUSTRIES THROUGH THE STOCK EXCHANGE, IT WILL BE MUCH MORE DIFFICULT TO LOCATE BUYERS ABLE TO MAKE LARGE CAPITAL COMMITMENTS OR TO TAKE OVER MANAGEMENT. PROSPECTS FOR FINDING BUYERS FOR THE MANY UNPROFITABLE OPERATIONS ARE EVEN POORER, PARTICULARLY SINCE MOST OF THESE ARE UNDER HEAVY GOVERNMENT REGULATIONS.
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PAGE 02 TEL AV 00451 03 OF 04 111231Z

H. INVESTMENT. AS NOTED ABOVE, FOREIGN INVESTORS HAVE NOT YET REACTED TO THE NEP. ISRAELI BUSINESSMEN ARE AVOIDING MAJOR CAPITAL COMMITMENTS UNTIL GOVERNMENT

POLICY AND THE EFFECTS OF THE NEP ON THEIR PARTICULAR CASES BECOME EVIDENT. THE REVISED AND SIMPLIFIED INVESTMENT CODE IS STILL BEING AWAITED.

I. FISCAL POLICY. AS THE EMBASSY HAS REPORTED PREVIOUSLY, THE GOI HANDLING OF THE 1978 BUDGET (TEL AVIV 10198) HAS NOT BEEN VERY ELEGANT. THE BUDGET IS CONSIDERED TO BE DISHONEST AND UNWISE BY A BROAD SPECTRUM OF ISRAELIS. AN IMF TEAM, WHICH SPENT SEVERAL WEEKS HERE IN DECEMBER, SUPPORTED THE GOVERNOR OF THE BANK OF ISRAEL IN HIS CHARGES THAT THE BUDGET WAS INFLATIONARY ON THE ONE HAND (TOO MUCH OF IT WENT FOR CONSUMPTION) AND STINGY ON THE OTHER (TOO LITTLE INFRASTRUCTURE INVESTMENT). THE BUDGET WAS REWORKED AND WAS FORWARDED TO THE KNESSET ON JANUARY9, A WEEK LATER THAN IS CUSTOMARY. EVEN THE REVISED DOCUMENT PROBABLY WILL BE SUBSTANTIALLY MODIFIED BY SUPPLEMENTAL BUDGETS LATER IN THE YEAR.

J. MONETARY POLICY. A COMBINATION OF FACTORS HAS KEPT MONEY SUPPLY GROWTH IN NOVEMBER AND DECEMBER TO ONLY 2PERCENT, DESPITE CONTINUING LARGE DEFICIT SPENDING BY THE CENTRAL GOVERNMENT. THE BANK OF ISRAEL RESEARCH DEPARTMENT SAYS THAT ACCUMULATION OF FOREIGN CURRENCY BALANCES BY ISRAELIS IN RESIDENT ACCOUNTS, THE MAINTENANCE OF TRANSACTION BALANCES BY PARTICIPANTS IN THE STOCK MARKET AND CERTAIN SEASONAL FACTORS HAVE BEEN PARTIAL OFFSETS TO CENTRAL BANK LENDING TO THE GOVERNMENT.

3. REACTIONS:

A. THE GENERAL PUBLIC. MOST ISRAELIS SEEM TO ACCEPT THE NEP'S PHILOSOPHICAL ASSUMPTION THAT LESS GOVERNMENT INTERFERENCE IN THE ECONOMY IS DESIRABLE. THERE HAS BEEN LIMITED OFFICIAL USE

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PAGE 03 TEL AV 00451 03 OF 04 111231Z

A SURPRISING LACK OF CRITICISM OR ORGANIZED RESISTANCE TO NEP MEASURES, SUCH AS THE REDUCTION IN SUBSIDIES, WHICH DIRECTLY AND IMPORTANTLY AFFECT MOST OF THE PUBLIC. ON A MORE PERSONAL LEVEL, THE ISRAELI BUYING SPREE WHICH IMMEDIATELY FOLLOWED THE ANNOUNCEMENT OF THE NEP WAS SHORT-LIVED AND RETAIL SALES REPORTEDLY WERE OFF SHARPLY IN NOVEMBER--ESPECIALLY OF DURABLE GOODS. RETAIL SALES REPORTEDLY REVIVED SOMEWHAT IN DECEMBER. BETTER-HEELED ISRAELIS HAVE BEEN MAKING ADJUSTMENTS IN THEIR FINANCIAL PORTFOLIOS AND THIS HAS CONTRIBUTED TO A ROLLER COASTER PATTERN IN THE STOCK MARKET IN THE PAST TWO MONTHS. THE MARKET HAS RETREATED FROM ITS HISTORICAL HIGH IN NOVEMBER BUT CERTAIN BANK STOCKS AND C-O-L LINKED ASSETS HAVE REMAINED IN STRONG DEMAND.

B. BUSINESS. PRIVATE SECTOR BUSINESSMEN TEND TO BE CRITICAL ABOUT MANY OF THE DETAILS AND IMPLEMENTATIONS OF THE NEP, BUT THEY REMAIN SYMPATHETIC TO ITS GENERAL INTENT. IN TERMS OF THEIR OWN PRIVATE BUSINESS DECISIONS,

THEY ARE WAITING-AND -SEEING.
C. LABOR. AS MENTIONED IN PARA 2, THE
HISTADRUT HAS BEEN MOUSE-LIKE. THEIR MAJOR OBJECTIVE
HAS BEEN TO PROTECT THE REAL INCOME OF THEIR CONSTITUENTS.
THEY PROBABLY HAVE FALLEN A BIT SHORT OF THEIR GOAL FOR
THE NEXT FEW MONTHS.

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PAGE 01 TEL AV 00451 04 OF 04 111257Z
ACTION NEA-10

INFO OCT-01 ISO-00 NEAE-00 AID-05 CIAE-00 COME-00
EB-08 FRB-03 INR-07 NSAE-00 USIA-06 TRSE-00
XMB-02 OPIC-03 SP-02 LAB-04 SIL-01 OMB-01 NSC-05
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AMEMBASSY BEIRUT
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LIMITED OFFICIAL USE SECTION 4 OF 4 TEL AVIV 0451

D. POLITICAL PARTIES. NONE OF THE OPPOSITION PARTIES
HAS NOUNTED AN EFFECTIVE CAMPAIGN AGAINST THE NEP SO FAR.
THE GOI HAS BEEN LUCKY IN THAT NEWS OF THE MIDDLE EAST
PEACE NEGOTIATIONS HAS DRIVEN EVERYTHING ELSE OFF THE FRONT
PAGES. THE PROSPECT OF PEACE HAS CREATED A EUPHORIA
WHICH MAKES MUNDANE ECONOMIC INTERESTS SEEM UNIMPORTANT.
ALSO, THE OPPOSITION PARTIES ARE CAREFUL IN CRITICIZING
THE PRESENT GOVERNMENT BECAUSE OF THEIR LESS THAN BRILLIANT
RECORD IN MANAGING THE ECONOMY BEFORE MAY 1977. IT COULD
WELL BE THAT THE MOST SEARCHING EXAMINATION OF THE NEP WILL
COME EVENTUALLY FROM WITHIN THE LIKUD COALITION, WHERE THE
HERUT FACTION CHAMPIONS THE INTEREST OF ISRAEL'S LOWER
ECONOMIC STRATA.
E. ECONOMISTS. ISRAELI ECONOMISTS BY AND LARGE CONTINUE
TO FAVOR THE GENERAL THRUST OF THE NEP BUT ALMOST UNANIMOUSLY
CONDEMN ITS IMPLEMENTATION THUS FAR. THEIR FOCUS

IS MAINLY ON THE CONTRADICTORY AND UNCERTAIN
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PAGE 02 TEL AV 00451 04 OF 04 111257Z

SIGNALS CONTAINED IN THE 1978 BUDGET. THEY STRESS THE NEED
FOR INCENTIVES TO SAVE AND TO INVEST SO THAT ISRAEL CAN
RETURN TO ITS PRE-1974 HIGH GROWTH PATH.

4. EMBASSY COMMENT:

THE GOI HAS NOT COVERED ITSELF WITH GLORY IN FOLLOWING
UP ON ITS "REVOLUTIONARY" ECONOMIC POLICY. OTHER THAN
THE FOREIGN CURRENCY REFORM, NOTHING MUCH IS DIFFERENT
TODAY THAN IT WAS UNDER THE PREVIOUS SYSTEM--EXCEPT
PUBLIC EXPECTATIONS. ALTHOUGH THE IDEOLOGICAL BASE HAS
CHANGED, OPERATIONAL DECISIONS ARE STILL VERY MUCH AD HOC.
HOWEVER, THE GOVERNMENT'S RECORD IS BETTER THAN SOME OF
ITS CRITICS WOULD ADMIT. REAL WAGES PROBABLY WILL NOT
INCREASE AND MAY EVEN DECLINE SLIGHTLY IN THE FIRST HALF
OF 1978, AND THIS WILL BE ACHIEVED WITHOUT THE HIGH COST
OF A GOVERNMENT-LABOR CONFRONTATION. ISRAEL MAY HAVE A
DE FACTO INCOMES POLICY EVEN THOUGH ORGANIZED LABOR
WILL BE UNWILLING TO RECOGNIZE IT DE JURE. IN OUR
OPINION, NO GREAT HARM WILL BE DONE TO THE ECONOMY IF
THE GOI CAN GETS ITS ACT TOGETHER BY MID-YEAR. ADVERSELY
AFFECTED ENTERPRISES, SUCH AS SOME INDUSTRIES,
CAN CONTINUE TO OPERATE UNDER PRESENT DIFFICULTIES FOR
AWHILE. SINCE SOME OF THEM WILL NOT BE ABLE TO SURVIVE
OVER THE LONGER TERM WITHOUT SPECIAL GOVERNMENT ASSISTANCE,
WE BELIEVE IT LIKELY THAT THE GOI WILL EVENTUALLY DECIDE
TO REINSTITUTE A LIMITED NUMBER OF EXPORT SUBSIDY PROGRAMS.
ISRAELIS OF ALL PERSUASIONS ARE HOPING, OF COURSE, THAT
A NEW SET OF CONDITIONS WILL PREVAIL BY MID-1978 IN WHICH
ISRAEL WILL BE AT PEACE WITH MOST OR ALL OF ITS
NEIGHBORS FOR THE FIRST TIME IN ITS HISTORY AND WILL
HAVE A WHOLE NEW SET OF ECONOMIC HORIZONS.
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